

June 15, 2007

Mr. Winston Hickox
Chair, California Market Advisory Committee
California Environmental Protection Agency
1001 I Street
Sacramento CA, 95814

Re: SCE Comments on the California Market Advisory Committee Draft Report
to the California Air Resources Board

Dear Mr. Hickox,

Southern California Edison (SCE) appreciates the opportunity to submit these comments following the June 12, 2007 meeting of the California Market Advisory Committee (CMAC).

In Assembly Bill (AB) 32, California established an aggressive goal of reducing statewide greenhouse gas (GHG) emissions. SCE is committed to working with the CMAC, other state agencies and stakeholders to achieve that goal. SCE recognizes the challenges and effort of the members of the CMAC to provide recommendations to CARB and commends the CMAC for its well designed, thorough and thoughtful Draft Report.

Scope of Regulation

The CMAC Draft Report endorses a market-based approach to achieve AB 32 compliance. The Draft Report recognizes the significant cost savings realized from a cap-and-trade approach compared to command-and-control alternatives. SCE agrees with the Draft Report's finding that a market-based approach provides an opportunity for real, sustained emissions reductions at a lower cost to California ratepayers and the California economy as a whole. SCE agrees with the Draft Report's recommendation that a First Seller structure will enable California to incorporate emissions from imported energy into the emissions cap along with emissions from in-state generation. Additionally, a First Seller approach can facilitate more transparent and straightforward reporting and measurement of emissions from in-state generation. In its May 17, 2007 letter to the CMAC, SCE expressed concern that a load-based approach may not best coordinate with the smooth functioning of electricity markets. By contrast, a First Seller approach can more easily be constructively coordinated with the operations of electricity markets in California.

The California Public Utilities Commission and the California Energy Commission have placed Energy Efficiency (EE) at the top of the stacking order in California. As the Draft

Report correctly recognizes, load serving entity (LSE) incentives to pursue greater customer energy efficiency in order to reduce emissions associated are not fundamentally different under a First Seller approach as compared to a load-based cap-and-trade approach. Indeed, as energy prices rise to incorporate the cost of emissions, additional EE projects are likely to become cost effective. Thus, a First Seller approach is completely consistent and compatible with increasing the level of EE investment in California.

Concern over potential emission leakage was a key driver in the initial consideration of a load-based cap-and-trade structure. SCE agrees with the Draft Report's conclusion that the potential for leakage is no different under a First Seller approach than it is under a load-based cap-and-trade structure. Thus, in view of the other advantages of a First Seller approach over a load-based cap, SCE supports CMAC's endorsement of the First Seller structure.

SCE encourages the CMAC to endorse a more comprehensive approach to cap-and-trade at the outset. All carbon-regulated sectors should be included within the scope of trading as soon as possible and a phased-in approach should be avoided. As the CMAC members are most certainly aware, a cap-and-trade system will be most effective when designed to include a wide variety of sectors that are free to trade allowances under an emissions cap. Including many sectors will present regulated entities with a wider range of choices for achieving compliance, resulting in a lower cost to California's economy. Thus, SCE encourages the CMAC to further consider development of a trading regime that would include the transportation sector.

Offsets

The Draft Report endorses the use of offsets without geographic or quantitative restrictions. However, as noted in the Draft Report, there was not complete agreement among CMAC's members on this point. Offsets present California with an important tool for developing real, verifiable, and additional emission reductions at a lower cost. Therefore, for any given level of economic sacrifice, California will be able to accomplish larger reductions in GHG emissions if broad-based offsets are allowed. Geographic flexibility in developing offsets is particularly important for California. California has a strong history of supporting renewable and environmentally friendly energy sources. Additionally, through various local and statewide regulations and initiatives, California has become a leader in environmental protection. Because California has done so much, many of the most cost-effective projects to reduce emissions can be found outside of California. Because offsets are such an environmentally valuable tool, any rule that would restrict the quantity of emission reductions that may be obtained via offsets will unnecessarily increase the cost of compliance with AB 32 and hinder the continued growth of the California economy. SCE agrees with the Draft Report's finding that high-quality eligible offsets should not be subject to quantity or geographic restrictions.

Localized Air Quality Impacts

The Draft Report recognizes that with GHG emission reductions comes the reduction of criteria pollutants but that existing environmental regulations and air quality standards will prevent the development of any local hotspots. SCE fully supports this conclusion. Continued monitoring and enforcement of existing air quality regulations will provide important reassurance that adverse local impacts will not occur.

Allowance Allocation

In its May 17, 2007 letter, SCE recommended that emission allowances be allocated in a way that mitigates economic displacement and harm to carbon-regulated companies and their employees. The Draft Report correctly notes that LSEs cannot capture economic rents from freely allocated allowances. SCE agrees with the Draft Report's conclusion that allocation to LSEs would be an effective way to mitigate the cost of AB 32 compliance to ratepayers. However, the CMAC did not fully endorse complete allowance allocation. Because emission allowances will be required for all GHG emissions, the cost of allowances could dwarf the cost of reducing emissions, resulting in much higher costs for California consumers. The cap-and-trade system will establish a value to emission reductions and as such will motivate entities to reduce emissions. The allocation method itself will not affect the emission reduction decisions of carbon-regulated entities. However, the ability of a carbon-regulated entity to pass along its GHG mitigation costs to customers will vary across industries. As a result, it is important to allocate allowances in a manner which will mitigate economic harm to all carbon-regulated entities and mitigate severe economic displacements.

Additionally, the allowance allocation method should recognize historical and existing activities undertaken to reduce emissions. California investor owned utilities (IOUs) have a long, successful history of energy efficiency, renewable energy development and support for programs that have produced real emission reductions. An allowance allocation should recognize these efforts.

Benefits of Electrification

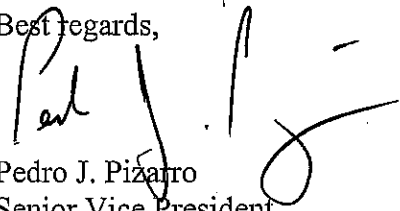
The electricity sector can be a valuable tool in California's efforts to reduce GHG emissions. SCE welcomes the opportunity to contribute to emission reductions via electrification of processes traditionally powered by fossil fuel combustion engines. However, with such initiatives, demand for electricity will increase and as a result emissions directly attributed to the electricity sector could increase. As such projects become operational the CARB will need to recognize the impact on California electricity generation. LSE ratepayers should be protected from paying for the emission reductions more properly attributed to non-electric sectors.

Flexible Compliance

The CMAC does not endorse an allowance price cap in the Draft Report. The Draft Report concludes that because a price cap or "safety valve" could result in a regulated entity not meeting an emissions target for a compliance period, a price cap would be inconsistent with AB 32. However, AB 32 enables a delay or short term adjustment of the compliance obligation. Specifically, the legislation provides for the Governor to take certain actions to adjust the compliance deadlines under extraordinary economic circumstances.¹ Consistent with this legislative philosophy and objective, there are forms of flexible compliance which can protect consumers from excess volatility without undermining the goals of AB 32. Thus, SCE recommends that the CMAC reconsider its recommendation and explore compliance options that allow temporal flexibility. Whenever the supply of a good is restricted, policy-makers must address the potential exercise of market power. SCE remains concerned about the possibility that innovative policy and electricity markets could adversely interact in unforeseen ways. California experienced such an event during the 2000-2001 electricity crisis, when the price of RECLAIM trading credits increased dramatically, forcing a temporary suspension of this program. A similar course of events in the emissions allowance market could erode public support for AB 32 and would needlessly risk the economic stability of the California energy market.

Thank you again for the opportunity to submit these comments. SCE looks forward to working with the CMAC, other state agencies and stakeholders to achieve the emission reduction goals established in AB 32.

Best regards,



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¹ Health and Safety Code, Section 38599 (a) (b)

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